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Effects of Political Process on the Economic Performance of a Country: A Case of Kenya General Elections

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Abstract
This research paper addresses the effects of political processes on the economic performance in Kenya. The research forms a framework for understanding the policy and individual decisions that investors and leaders have to consider when making sound investment decisions. These have been based on the identification of concrete financial and economic issues from the results of comprehensive and in depth research carried out through secondary research, and also study of related finance and banking journals.
Purpose**:** The core intent of this research was to understand how key economic variables such as the stock market performance, foreign direct investment, interest rates and inflation rates are affected by political processes.
Methodology**:** The paper employed a secondary research design. The sample size of this research was estimated at 12 years. The data was analyzed using standard software. The variables were measured using correlation analysis.
Findings**:** A major finding of the research showed that election trends have a strong impact on the performance and stability of an economy.
Conclusion**:** This study is focused on the effects of political processes on the economic performance of a country with a case of a Kenyan scenario. Taken as a whole, our findings suggest that, there are some strong impacts associated with processes on the economic variables.
Keywords: *Political Business cycle, Political electioneering, Economic barometers*

1. Introduction

In any democratic economy, the process of achieving and predicting the level of economic growth and performance is often pegged against stability of the country's political environment. This according to Alesina et al., (1997) implies that voters tend to cast their votes based on the economic parameters such as inflation rates, interest rates, performance of the money markets as well perception on foreign investment. The objective of the policymaker is to maximize his probability of reelection. Voting behavior is retrospective, in that it depends on economic performance under the incumbent in the past (Kim and Mei, 2001).

Economic performance in a period is measured by the behavior of inflation and unemployment. It should be noted that if voting were based on economic performance in the recent past and if expectations of inflation were backward-looking, an opportunistic incumbent who controlled monetary policy would find it optimal to induce an inflation-unemployment cycle corresponding to the length of his term, with a boom just before an election and a recession afterwards (Bernhard and Leblang, 2002). In order to win voters, an opportunistic policymaker will choose the policy that attracts most voters, so that the projected policies could be thought of as representing the preferences of the median voter. However in most cases, the voting pattern depends on past incumbent performance, and expectations of money growth depend only on past inflation rates (Berg et al., 2003b).

Harms (2002) inferred that an incumbent president may tend to be manipulative and opportunistic of the elections and may design policies likely to influence voters' decisions to support the government. Immediately preceding an election the government stimulates the economy via expansionary monetary policy (Easaw and Garatt, 2000). The levels of monetary expansion and economic activity are those that maximize voter satisfaction in an election period taken alone. In the period immediately after the election, the government reverses course. It engineers a recession via contractionary monetary policy to bring down inflationary expectations. The incumbent keeps economic activity low to keep expected inflation low until the period immediately before the next election, so that a given rate of economic expansion (induced by a monetary surprise) can be obtained at a relatively low rate of inflation (Kim and Mei, 2001). In the next election cycle, the same behavior is repeated.

When the electorate sees that its income is increasing and unemployment is falling, they may not consider the possibility that these are short-term positive shocks and that the tradeoffs for these distortionary endeavors will inevitably increase taxes and price levels in the long run. Berlemann and Markwardt (2006) extend this analysis to include forward looking expectations, explaining that voters will incorporate speculative expectations into their assessment of macroeconomic indicators, helping to explain why, incumbent politicians who preside over a strong economy are more likely to be reelected for another term.

It has also been found out by Brastiotis (2000) that the change in real economic activity in the year of the election, as measured either by the change in real per capita GNP or the change in unemployment in the election year, does appear to have an important effect on votes for president. Specifically, a 1% increase in the growth rate increases the incumbent's vote total by about 1%. Therefore this research paper seeks to find out the effect of a country's politics on its economic performance, with greater attention being directed at money market performance, foreign direct investment, interest rates, inflation rates and effect on private and public investments on investors attitudes.

1.2 Problem statement

The economic performance of any developed and developing countries is often pegged on number parameters, which include but limited to: the performance of the stock markets, foreign direct investment, inflation rates and interest rates. These parameters are affected majorly by the political stability/instability of any country, which is equally affected by the electoral process in the country. Most electoral processes and outcomes in developed and developing countries are marred with a lot of uncertainties which affect investors' attitudes. As regimes change so do the economic policies of different countries which in turn impact the investment decisions by investors. The main intent of this research therefore was to assess the effects of politics and electoral processes on performance of any economy, with a focus on Kenyan perspective.

1.3 Research objectives

This research was guided by both general and specific objectives

1.3.1 General objective

The main intent of this paper was to investigate the effects of politics on a country's economic performance.

1.3.2 Specific objectives

The research specific objectives were

(i) To ascertain the effects of political processes on inflation rates.
(ii) To determine the effects of political processes on money market performance
(iii) To find out the effects of political processes on foreign direct investment and funding
(iv) To establish the effects of political processes on interest rates

2.0 Literature Review

This section presents a brief review of the literatures on effects of political electorate on money markets performance, foreign direct investment (FDI), interest rates, Inflation rates and effect on private and public investment.

2.1 Effect of Elections on inflation rates

There are different findings which suggest that the fall in the inflation rate in the post-election environment does not necessarily reflect the degree of institutional development. As political budget cycle theory predicts, a lower level of democracy may translate into higher government spending before an election, given greater budgetary discretion and fewer checks on government actions and accountability under these regimes (Bernhard and Leblang, 2002). However, there remains no evidence supporting the notion that such spending produces deleterious economic outcomes following elections. Other political factors may instead be at work. The fall in inflation could be a reaction of an executive's stronger reform mandate following elections, and hence his or her ability to pursue stabilizing macroeconomic policies (Berg et al., 2003b).

Remer's political capital hypothesis suggests that electoral victory may strengthen the hand of government authorities and serve as a catalyst for politicians to initiate reforms and implement effective policies (Remer, 1993). Another theoretical possibility is that elections may produce an alteration of political power, where incumbent politicians are voted out of office due to their unsuccessful macroeconomic policies following an economic crisis or severe financial stability. In such a scenario, the newly elected government might possess a popular mandate to initiate difficult, yet stabilizing economic reforms. In contrast to PBC theory, these mechanisms suggest that elections might enhance rather than undermine the ability of governments to respond to macroeconomic challenges (Alesina, et al., 1997).

The post-election fall in inflation may instead be a function of market perceptions, rather than a function of government policy. Fearing the election of a left-wing government, market participants may sell domestic assets to hedge against potential profligate spending policies, inflation, debt pressures and negative risk assessments by sovereign rating agencies (Block, et al., 2002). Following elections, if the left-wing government signals a shift to orthodox, market friendly policies, inflation expectations are likely to diminish, helping financial markets rebound. The resulting lower rate environment could also help expand domestic credit and spur economic activity.

2.2. Effects of political elections on interest rates

Alesina (1987) assumes future policies of election winners are fixed and known, but it is much more likely that there is some degree of uncertainty surrounding them. This uncertainty may result from not knowing exactly what economic policies a given party prefers and the inflation that would result if they were implemented. Even though it may be easy to rank-order the impact of Left and Right policies, it may be difficult to know if the victorious party will implement the moderate or extreme version of its proposals. Uncertainty may also arise because the effectiveness of a government in implementing policy varies, in part due to changing logistical competence and in part due to idiosyncrasies of the current institutional context (such as the personalities controlling legislative committees).

Policy uncertainty can have an effect on the real economy. A higher level of policy uncertainty increases the risk of holding assets with returns that depend on economic policies. For example, the decision to invest in a government bond is directly affected by the inflation rate since the real rate of return is equal to the nominal return minus the inflation rate. Any increase in the expected variance of inflation also increases the expected variance of the real return. This causes some investors to reallocate their money to other assets that have the same return but a lower level of total risk. As they do so, demand for the bond falls, as does its price. Thus, an increase in inflation risk increases interest rates, which can also have a negative impact on consumption, investment, and growth.

2.3 Effects of General elections on Money market performance

The stock market is a national economy barometer in that it speculates on the future of the economy. Thus political information easily spreads into the stock market with consequent mass media development. It generally responds to new political information that may affect the national economy future. Hence, whether or not political change influences the stock market continues to be an important analysis for scholars and market participators (Kim and Mei, 2001; Perotti and Oijen, 2001; Hassan *et al.*, 2003).

Exploring complicated relationship between stock market and political behavior using statistical methods is one of most exciting issues for academicians and investors. Politics and that economy are inextricably linked; that is, they have significant influence on each other, and cannot be separated (Bratsiotis, 2000; Cover, 2000; Easaw and Garratt, 2000; Harms, 2002; Chiu *et al.*, 2005).

Recent research has further examined market efficiency issues by examining stock market responses to uncertain political events. Most empirical investigations have focused on tracking financial market movements in relation to elections (Brüggelambert, 2004; Chiu *et al.*, 2005). Major studies supported the presidential election cycle, in which a country’s stock markets make larger gains in the third and fourth year of a presidential term, while average returns in the second year are negative. Other studies have focused on stock market preference (Santa-Clara and Valkanov, 2003).

Further empirical studies examined various types of political information impact on stock markets (Pantzalis *et al.*, 2000; Harms, 2002; Lin and Wang, 2007). While a prosperous domestic economy cannot guarantee victory for the ruling party, economic decline is frequently a catalyst for party change, based on the above. That political change strongly correlates to the stock market is one motivation behind this study. Various political events significantly influence stock market behavior, however, only a few academic researchers have explored stock market behavior responses to political changes. Therefore, the present study applied event study and panel data to examine how stock market behavior reacts to long- and short-term political uncertainty, such as political changes in developed countries.

Stock market participants will price their expectations about political change into stock prices prior to an election and adjust their opinion according to the actual political decision making after the election and inauguration took place (Pantzalis *et al.*, 2000). In the U.S., presidential elections are a key inflection point of change in the political landscape. As such, an increasing likelihood of a candidate’s victory should be reflected in stock prices. However, expectations about election results are not always clear-cut. Therefore, futures markets increase in volatility in tight elections due to uncertainty about election results and their implications (Jones 2008). Leading up to an election, information asymmetry has been shown to exist between the market and political parties.

2.4 Effects of politics on Foreign Direct investment and International funding

When seeking to woo voters and create new regimes, leaders tend to develop new policies that can be adopted into future projects should they win an election. Such policies will also determine the perception of the donors and funding agencies which in most cases tend to originate from different economies, such as socialist, capitalist and communist background. In order to gain full access to funding from these economies, leaders will try to adopt certain policies which can make such donors to stop their funding. These policies also tend to affect the attitudes of the foreign direct investments (Nooruddin 2010).

The flow of foreign investment and funding from different economies into countries with significant natural resources should not be taken as a given. Foreign investors/donors prefer that such countries also have stable and predictable investment environments that provide general standards of treatment and have predictable legislative and regulatory frameworks in which channels of negotiation are clear (Hassan *et al.*, 2003). Absent an enforceable framework defining ownership, taxation, dispute settlement, and regulation, they fear expropriation, onerous administrative intervention, and unpredictable laws and regulations (Pantzalis *et al.*, 2000).

The literature regarding the performance of FDI has largely been discussed by different scholars.

Chiu et al., (2003) noted that FDI locates in countries that can commit credibly to economic policies. The logic is straightforward. Because of the large fixed and difficult-to-reverse costs associated with FDI, capital owners know that once they invest in another country, they are at a weaker bargaining position vis-à-vis the host country government than they were *ex ante* (Nooruddin 2010).

Investors and donors know that politicians suffer from time-inconsistency problems wherein they might offer favorable economic policies to lure investment only to expropriate investment returns *ex post* when the investment is sunk (Jensen, 2006). Indeed, in the extreme, host country governments may nationalize the foreign firm altogether, although this is increasingly rare. When deciding where to locate, then, investors consider the likelihood of this sort of opportunistic behavior. Consequently, the literature finds that countries able to make credible policy commitments are far more attractive to FDI (Jensen 2003).

2.5 Effects Political election on Public and Private Investment in a country

Several empirical and theoretical studies have been carried out to establish the underlying relationships between investment and political uncertainty. It should be noted from (Jensen, 2003) that cycle in corporate investment corresponding with the timing of national elections around the world. During election years, firms reduce investment expenditures by an average of 4.8% relative to non-election years, controlling for growth opportunities and economic conditions (Nooruddin 2010).

Elections around the world provide a natural experimental framework for studying political influences on corporate investment, allowing us to disentangle some of the endogeneity between economic growth and political uncertainty. If political uncertainty is higher when changes in national leadership are more probable, elections provide a recurring event that helps isolate the impact of policy uncertainty on investment from other confounding factors. The timing of elections is out of the control of any individual firm and indeed fixed in time by constitutional rules for a large population (Bloom et al., 2007).

The intuition underlying the relationship between electoral uncertainty and investment is simple: if an election can potentially result in a bad outcome from a firm's perspective, the option value of waiting to invest increases and the firm may rationally delay investment until some or all of the policy uncertainty is resolved. The relationship between uncertainty and real investment has been modeled by Bernanke (1983) and Bloom, et al., (2007), among others. In these models, firms become cautious and hold back on investment in the face of uncertainty.

The increase in cash holdings is similar in magnitude to the election-year decline in investment, suggesting that the funds that would have been used as investment are temporarily held as cash until the election uncertainty is resolved. This has also been noted from Nordhaus's (1975) model of political business cycles, there has been much debate over whether incumbents manipulate fiscal and monetary policy instruments to influence the level of economic activity prior to an election in order to maximize the probability of reelection. Therefore it is evident that the timing of the election year and post election events tends to make investors to reduce on their investments in a country (Boutchkova et al., 2010).

3.0 Research Methodology

3.1 Research Design

This is an empirical study analyzing the economic performance before and after the general elections in Kenya. The period of study focused on GDP performance for the period between 1991 and 2008. This period was selected because during this general election competitive presidential, parliamentary and Civic elections were held compared to previous general elections which did not include presidential elections. The GDP index performance during this period was analyzed and the performance of the GDP index during election years compared to none election years

3.2 Data collection

The study used secondary data from the Kenya Bureau of Statistics. The Data obtained on GDP covered the period between 31st January 1991 and 30th September 2008. The date of each general election held in Kenya in the years 1992, 1997, 2002 and 2007 was the event date. The event dates were 29th December 1992, 29th December 1997, 27th December 2002 and December 27th 2007. The study focused on GDP performance as measured using the developed economic barometers from the conceptual framework for the study period. A tabular representation has been represented in the table 3.2 below

3.3. Data Analysis

The main data variable for this study is the GDP index. The GDP index is used to measure the performance of the country from each economic year. An increase in GDP indicates that the country's economic performance is on an upward trend. Economic performance indicators, principally the GDP index and its economic variables were analyzed to capture trends of performance of the economy for the study period. The percentage increase or decrease in the GDP index before and after elections were calculated and a comparison done from one election period to another. For the purpose of this research, the author conducted simple technical analysis of the respective variables and data captured in technical graphs. In order to measure the relationship between depended and independent variables, the researcher conducted a Pearson's correlation analysis.

4.0 Results of the research

This research was conducted on two fronts, which involved technical analysis and correlation analysis.

4.1Technical analysis of the research variables

Technical analysis involved a deeper analysis across the trend, with greater attention being directed at the election year. However to be comprehensive enough, the researcher made a comparison of past and proceeding years after the election year.

Technical analysis between election year and the stock market performance, foreign direct investment, interest rates and inflation rates, showed a systematic trend, where it was noted that during the election year, the trend lines of these variables were seen to move in a downward trend. This was shown by the numbers 2, 5, 8 and 11, which represented the elections years of 1992, 1997, 2002 and 2007 respectively. It was noted that during the election years, few players are willing to invest at the stock market. Majority of the investors tend to fear, that the market may not perform positively and hence form poor attitudes towards the stability of the markets. Similarly other investors who are foreign based tend to withdraw their foreign direct investment, due to uncertainty in future economic policies of the incoming government.

It was also noted that interest rates tend to rise just before the election year and decrease after the elections have been casted and a new government ushered into power. Investors tend to refrain from purchasing government bonds, since they are speculate that the economy may not be stable, and this may contribute to inflation, that the reduces the real interest rates in the country. A summary of the information above has been presented in the graphs, 1, 2, 3 and 4 respectively of the appendices section.

4.2 Pearson Correlations between Political elections and Economic variables

After a Pearson correlation was carried out on the Political elections and Economic variables, it was noted that these economic variables are affected by political situation. The relationships between Political elections and Stock market performance showed a positive correlation of**.318** and a significant level of **.240**. There was also a positive correlation between political elections and Foreign Direct investment with a correlation of **.341** and significant level of **.0203**. A correlation analysis of political elections and interest rates was **0.296** with a significance level of 0.20. A comparison between political elections and inflation rates showed a weak correlation **of .027** and significant level of **.010.** As shown in the table below, it is clear that electioneering period plays a significant effect on the economic performance of a country. The summary of the findings has been presented in table 4.0 below.

4.3 Pearson Correlations between Political elections and stock market performance

The Pearson correlation showed **0.235** relationships and the significant level was **0.320.** The relationship shows that there is a significant positive correlation between Political elections and stock market performance. The two variables mobile Political elections and stock market performance shows that in every election trend, investors are likely to be influenced by an election trend. The results has been shown in the table below 4.1

4.4 Pearson Correlations between political elections and foreign direct investment

The Pearson correlation showed **0.351** relationships and the significant level was **0.007.** The relationship shows that there is a significant positive correlation between political elections and foreign direct investment. Foreign investors tend to be driven by election trend in a country. If they perceive that future policies are likely to be unfavorable, they will pull out their investment, implying that a country' elections have an impact on foreign direct investment. The results has been shown in the table 4.2 below

4.5 Pearson Correlations between Political elections and Interest rates

The Pearson correlation showed **0.293** relationships and the significant level was **0.129.** The relationship shows that there is a significant positive relationship between a country's elections and real interest rates. Increases in the inflation rates on bonds tend to push interest rates up. The demand for government bonds tend to decrease as election periods sets in. similarly, investors tend to prefer investing in external countries which they perceive to be economically stable. The results has been shown in the table 4.3 below

4.6 Pearson Correlations between Political elections and Inflation rates

The Pearson correlation showed **0.102** relationships and the significant level was **0.000.** The relationship shows that there is a significant positive weak correlation between political elections adoptions and inflation rates. The political elections adoptions and inflation rates shows that with the inception of electioneering period, there is increased inflow (circulation of money) of physical funds, which tends to increase in facilitating prices of commodities due to increased demand. The results has been shown in the table 4.4 below

5.0 Discussions and implication of the research

Current literature has highlighted the effects of political elections on the economic performance of a country, with case of Kenyan scenario. As argued by Bratsiotis (2000), voters tend to cast their votes based on the economic parameters such as inflation rates, interest rates, performance of the money markets as well perception on foreign investment. The objective of the policymaker is to maximize his probability of reelection. Voting behavior is retrospective, in that it depends on economic performance under the incumbent in the past. From the analysis, it was noted that investors tend to include forward looking expectations, implying that voters will incorporate speculative expectations into their assessment of macroeconomic indicators.

However it should be noted that the fall in the inflation rate in the post-election environment does not necessarily reflect the degree of institutional development from the election trends. As political budget cycle theory predicts, a lower level of democracy may translate into higher government spending before an election, given greater budgetary discretion and fewer checks on government actions and accountability under these regimes (Bernhard and Leblang, 2002). However, there remains no evidence supporting the notion that such spending produces deleterious economic outcomes following elections. This has been confirmed by the weak correlation analysis in our research.

From the analysis and the research findings, it was noted that interest rates tend be affected heavily by the presence of election trends. A higher level of policy uncertainty increases the risk of holding assets with returns that depend on economic policies. For example, the decision to invest in a government bond is directly affected by the inflation rate since the real rate of return is equal to the nominal return minus the inflation rate. Any increase in the expected variance of inflation also increases the expected variance of the real return. This causes some investors to reallocate their money to other assets that have the same return but a lower level of total risk. As they do so, demand for the bond falls, as does its price. Thus, an increase in inflation risk increases interest rates, which can also have a negative impact on consumption, investment, and growth. Political change strongly correlates to the stock market performance as noted from the research findings. Stock market participants will price their expectations about political change into stock prices prior to an election and adjust their opinion according to the actual political decision making after the election and inauguration took place (Pantzalis *et al.*, 2000). Thus in summary, the research has established some important implications, which investors and other players should consider when seeking to analyze and invest in an economy.

5.1 Research Limitations

This research was carried out following a Kenyan perspective and only applicable to its culture and way of life of her citizens. Therefore a major limitation is that it may not be applicable to other countries due to cultural differences and background.

5.2 Future work

This research was carried out based on the economic performance in Kenya while focusing on the electioneering trend. Future work may be carried out to investigate the social and financial effects of political trends on the stability of a country.

5.3 Conclusion

This study is focused on the effects of political elections on the economic performance of a country with a case of a Kenyan scenario. Taken as a whole, our findings suggest that, there are some strong impacts associated with elections on the economic variables. Even if these economic variables are in multiple levels to develop and maintain economic stability, it is imperative to study with more depth of these variables in order to better understand how they are affected by political process and such findings can help both planners and investors in their decision making.

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Appendices

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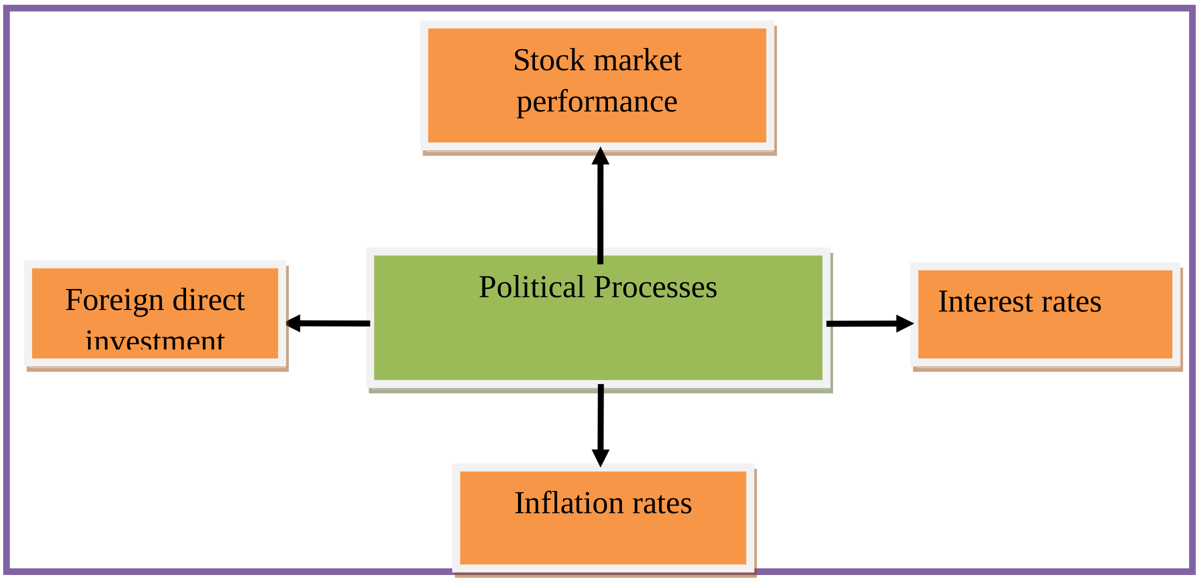
Fig 2.1: Conceptual Framework



Source: Author (2012)

Table3.2: Research sample

Year	1991	1992	1993	1996	1997	1998	2001	2002	2003	2006	2007	2008
value	1	2	3	4	5	6	7	8	9	10	11	12

Source: Author (2012)

Table 4.0: Pearson Correlations between Political elections and Economic variables

		Stock market performance	Foreign Direct investment	Interest rates	Inflation rates
Political elections	Pearson Correlation	**0.318**	**0.341**	**0.296**	**.027**
	Sig (2-tailed)	**.240**	**0.203**	**.220**	**.010**
	N	12	12	12	12

Source: Research Data, 2012

Table 4.1: Pearson Correlations Political elections and stock market performance

		Stock market performance
Political elections	Pearson Correlation	**.235**
	Sig (2-tailed)	.320
	N	12

Source: Research Data, 2012

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Table 4.2: **Pearson Correlations between political elections and foreign direct investment**

		Foreign direct investment
Political elections	Pearson Correlation	**.351**
	Sig (2-tailed)	.007
	N	12

Source: Research Data, 2012

Table 4.3: **Pearson Correlations between Political elections and Interest rates**

		Interest rates
Political elections	Pearson Correlation	**.293**
	Sig (2-tailed)	.129
	N	12

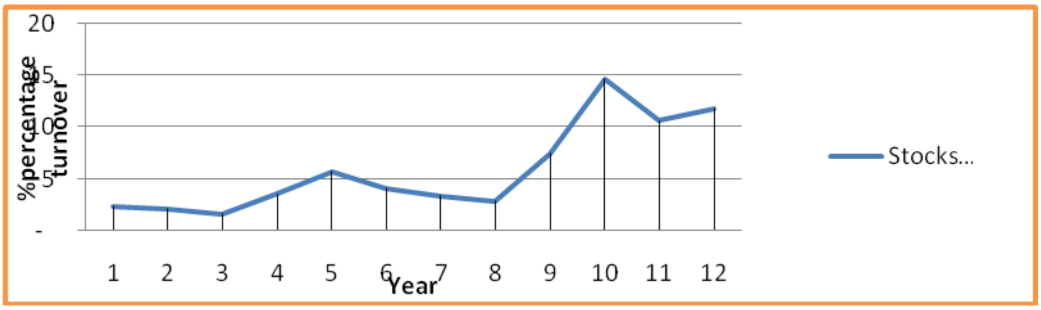
Source: Research Data, 2012

Table 4.4: **Pearson Correlations between Political elections and Inflation rates**

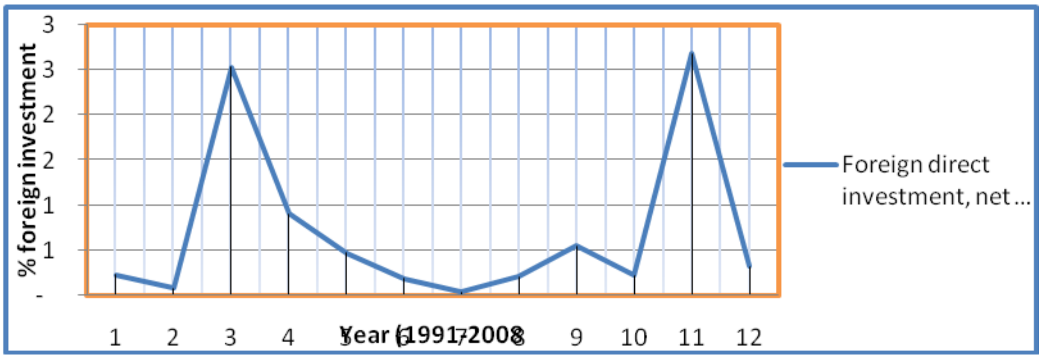
		Inflation rates
Political elections	Pearson Correlation	**.102**
	Sig (2-tailed)	.000
	N	12

Source: Research Data, 2012

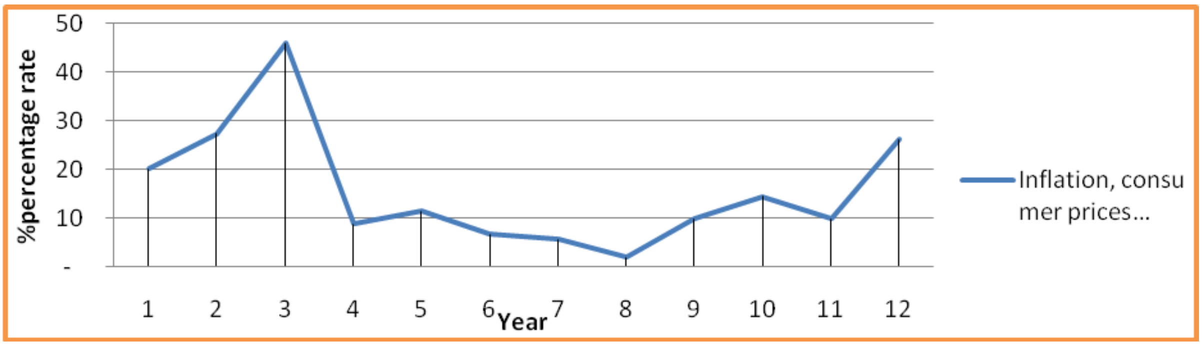
Graph 1: Technical representation of stock performance and



Graph 2: Technical representation of foreign direct investment and electioneering



Graph 3: Technical representation of inflation rates and electioneering



Graph 4: Technical representation of interest rates and electioneering